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DOW THEORY LETTERS

"The Market as Interpreted under the Dow Theory"

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THE MARKET The last Letter drew attention to the remarkable "holding power" of the Industrial Average in the face of persistent weakness in the Rails and the general market. For this reason it was suggested that "... any trading purchases be confined to the stronger stocks in the Industrial Average."

Since that time the action of the Industrial Average has proved the wisdom of the old adage: "The stocks that will not go down on a market decline will be the leaders on the next advance." In the space of six trading days (July 24 to August 1) the Industrial Average advanced 32 points to an all-time high. Over the same period Rails budged grudgingly higher, but the carriers are still lagging badly, and as of this writing the Rail Average has not even succeeded in hurdling its last minor peak at J (142.48). Thus, although Rails have tended to move in direction, they have not provided the most minor confirmation of the Industrial advance.

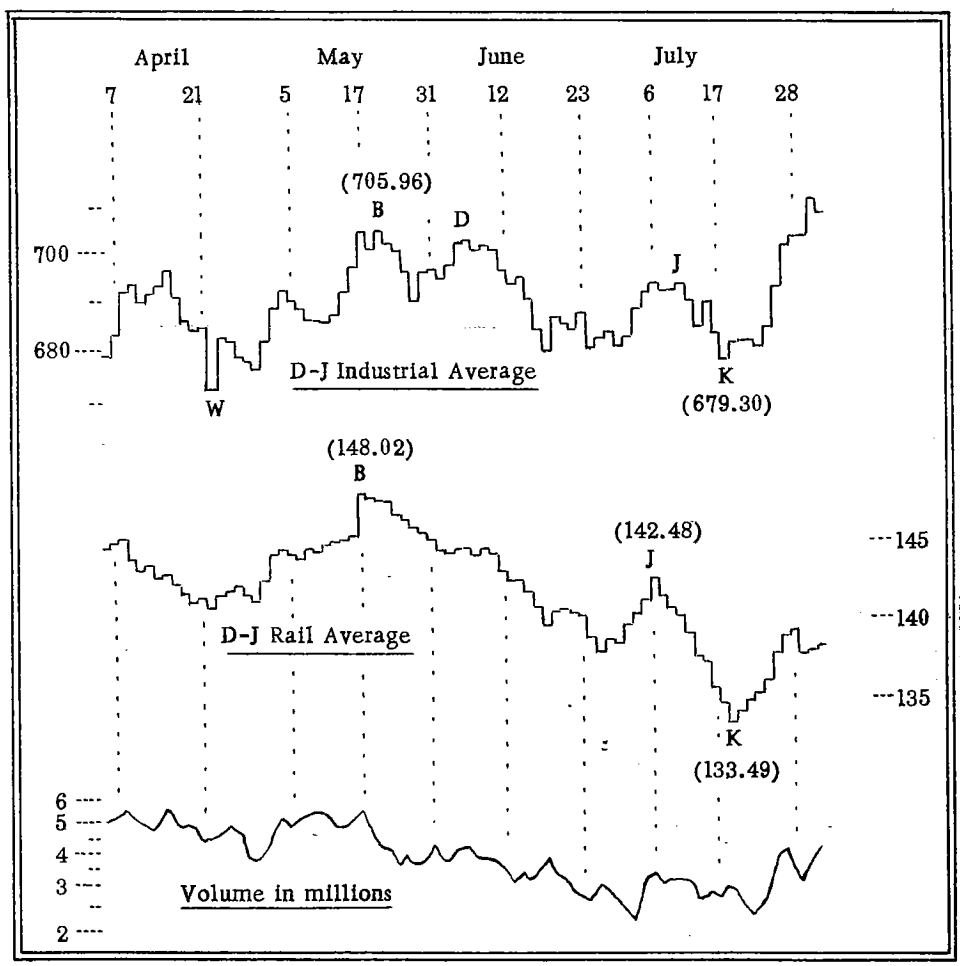
Volume has expanded with higher prices, but it has held well under the totals which were prevalent during March and April. The five-day moving average of new highs (see Letter 151) expanded to 50 on August 2, but this was far below previous totals which were recorded when the Industrial Average was considerably lower. The poor showing of new highs is merely confirming the fact that the majority of issues (see section in this Letter on the advance-decline ratio) have not kept up with the Industrial Average.

The elements of danger are obvious enough on the current advance. I continue to suggest that common stocks be viewed as trading or speculative mediums (not investments). It is also well to remember that stocks are easier to sell in a rising market than in a declining market. The yield on the D-J 40 Bond Average is now 5.17% against a yield of 3.02% on the D-J Industrial Average. The most unbridled optimism regarding future earnings cannot now justify stocks as "values".

TIMING One of the interesting studies which emerges from the current rise is the timing of the various technical indicators. Although we can never know (except in retrospect) whether an indicator has "topped out" or whether it will establish a new peak somewhere in the future, there is now enough evidence on the books to suggest that the chart on page 2 has validity.

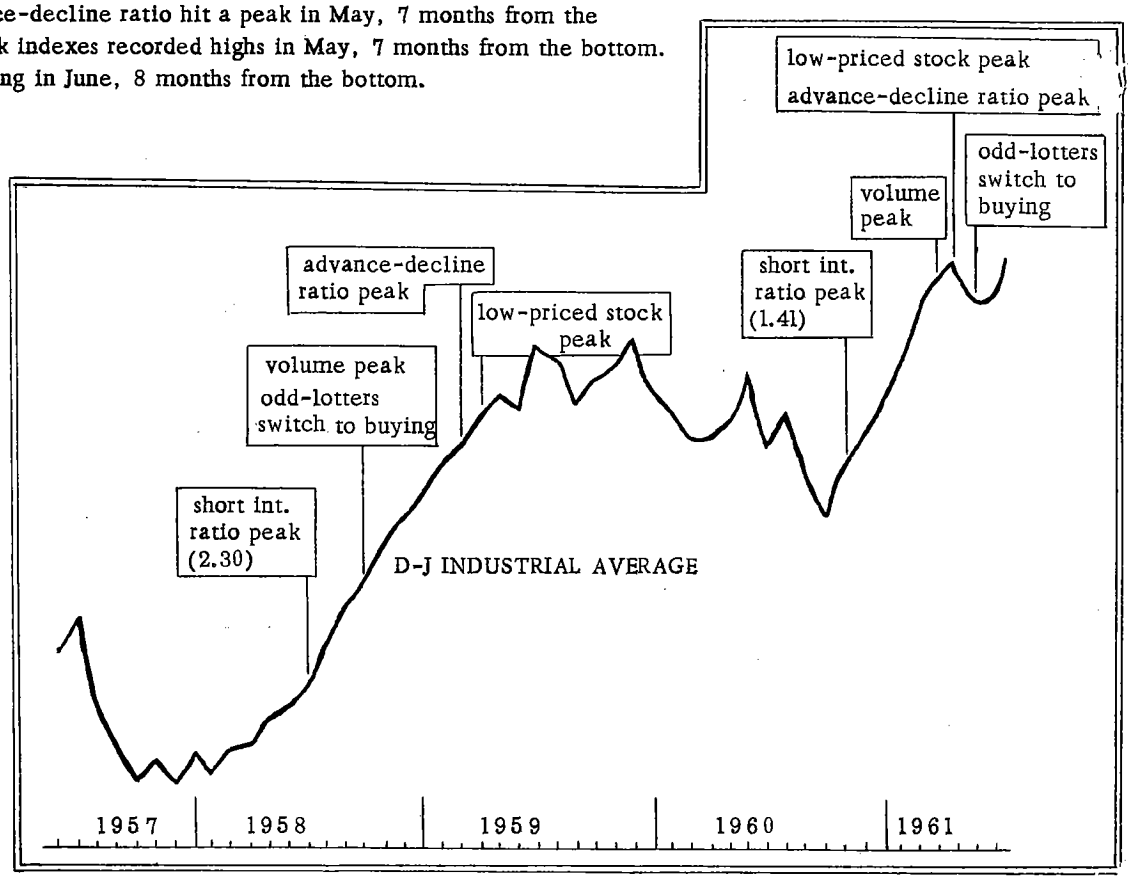
Referring to the great 26 month advance in the Industrial Average which took place during the October, 1957 to January, 1960 period, the various technical indicators recorded their peaks as follows: (1) The short interest ratio topped in July, 1958, 8 months after the October, 1957 bottom. (2) Volume peaked in October, 1958, 12 months from the bottom. (3) The advance-decline ratio recorded its high in March, 1959, 18 months from the bottom. (4) The low-priced stock indexes topped in April, 1959, 18 months from the bottom. (5) Odd-lotters switched from selling to buying in January, 1959, 14 months from the bottom.

In the current Industrial advance which began in October, 1960, the following are listed as



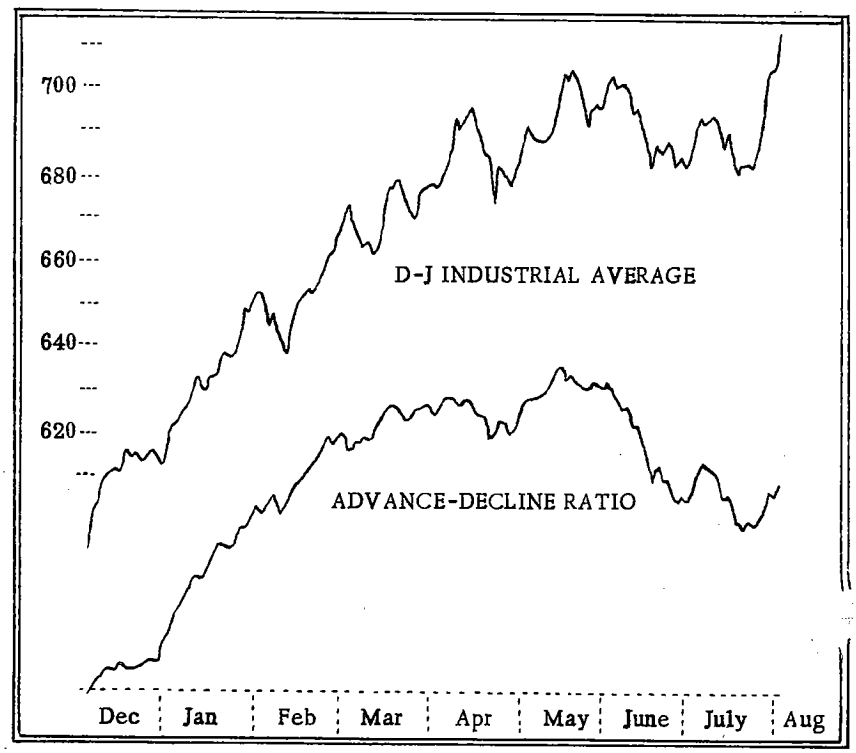
tentative dates for the peaks in the various indicators: (1) The short interest ratio topped in November, 1960, 2 months from the bottom. (2) Volume peaked in April, 1961, 6 months from the bottom (3) The advance-decline ratio hit a peak in May, 7 months from the bottom (4) The low-priced stock indexes recorded highs in May, 7 months from the bottom. (5) Odd-lotters switched to buying in June, 8 months from the bottom.

The average time which elapsed prior to the peaks on the five indicators in 1957-60 was 14 months. Average time on the five indicators during the swing which began in October, 1960 was 6 months. This suggests that the current cycle could last less than half as long as the 1957-60 cycle. If the current cycle lasts 11 months as compared to the previous 26 months of 1957-60, the top on the Industrial Average would be recorded around September of this year. Moreover, because of the now widely-publicized view concerning "a boom in 1962", I feel even more strongly that the top could occur within the next few months.



ADVANCE-DECLINE RATIO The chart shows the progress of the Industrial Average and the important A-D ratio (see Letter 150). Note that although the most recent rally took the Industrial Average well above the previous all-time high of 705.96, the A-D ratio is still lagging badly and has not even bettered its little peak established on July 6.

This is a clear case of "breadth" not confirming the action of the Industrial Average. Prior to almost all the major tops since the 1920's, the A-D ratio not only has refused to confirm a new Industrial high, but it has engaged in a period of divergence. On the next broad market decline, for instance, if the A-D ratio breaks to new low territory we will have the beginning of real divergence between the Industrials and the A-D ratio. Such action is extremely dangerous. Based on past history, a series of three or more lows on the A-D ratio against a series of successive highs in the Industrial Average would almost certainly spell the top.



SHORT INTEREST RATIO (S.I. RATIO) The S.I. ratio was last discussed in Letters 131 and 135. In my book "The Dow Theory Today" I included a chapter entitled "Tell-Tale Ratio" (Barron's article of December 28, 1959), and this also goes into the S.I. ratio in great detail. Consequently, I do not believe that it is necessary to examine the rationale of the S.I. ratio at this time. Suffice it to say that the S.I. ratio is derived by dividing the total short interest listed on the N.Y. Stock Exchange by the average daily volume over the same period. In general, a ratio figure above 2.0 is extremely bullish, a figure of 1.5 to 2.0 is bullish, 1.0 to 1.5 is neutral, below .8 is indicative of technical weakness, and anything below .6 to .5

is suggestive of a major top.

From March through July, 1958, the S. I. ratio rose above 2. 0 (see chart). Judging from previous history, this suggested that the market was "sold out", technically strong, and ready to move higher. The largest short position in history had been trapped in a primary bull trend, and the market turned up in a movement which was to take it from 419. 79 (October, 1957) to 685. 47 (January, 1960). In so doing, it would force the great mass of short sellers to "cover".

By January, 1960, the S. I. ratio had dropped to . 82. This resulted from a great increase in average daily volume and a steady drop in the total short interest (from over 6 million in 1958 to 2. 75 million in January, 1960). By early 1960 the bears had been routed and the market was technically weak.

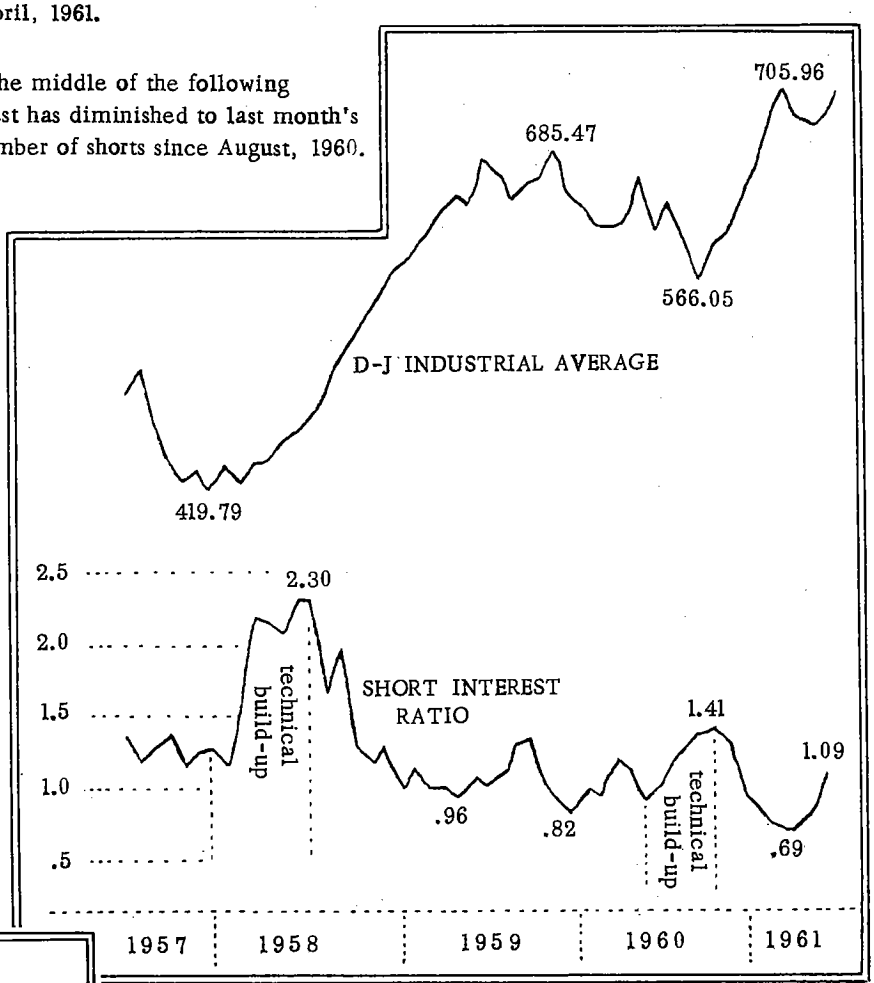
Following the January Industrial peak, the short position increased steadily to a December, 1960 high of 4. 4 million shares. The S. I. ratio struck its post-1958 peak in November, 1960, at 1. 41. From the 1960 high of 1. 41, the S. I. ratio dropped to an April, 1961 low of . 69. This drop was due to a tremendous increase in trading volume and a decrease in the total short interest from 4. 4 million in December, 1960 to 3. 7 million in April, 1961.

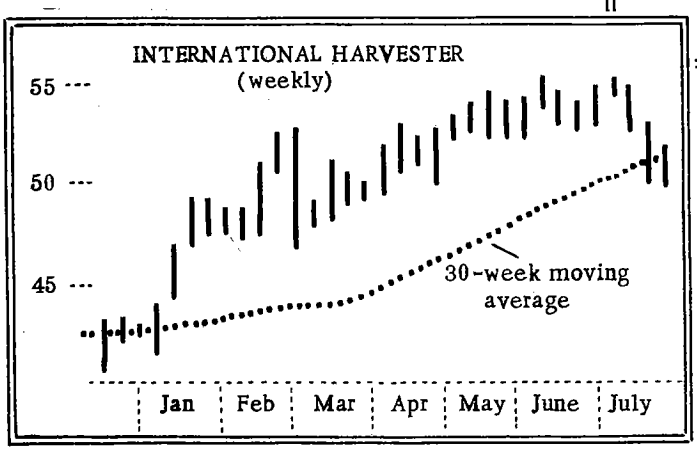
The Industrial peak of 705. 96 was recorded during the middle of the following month (May). Since that time the total short interest has diminished to last month's low of 3. 28 million shares. This is the smallest number of shorts since August, 1960.

Nevertheless, average daily volume, having hit its peak in March and April of 1961, decreased steadily as the market declined. This drastic diminution in trading volume more than offset the drop in the total short interest, and the result was that the S. I. ratio rose during the last three months to a July, 1961 high of 1. 09. The S. I. ratio is now in neutral territory.

It is probable that the 1960 high of 1. 41 on the S. I. ratio will stand as the high for the current advance. Even July's reduced average daily volume of 2. 9 million shares could only raise the S. I. ratio to 1. 09. And volume since the July posting has been averaging well above 2. 9 million shares.

STOCKS Five of the stocks in our continuing study of 17 key Dow stocks are now under their 30-week long term-moving average (M. A.). This is a considerable improvement over last week.





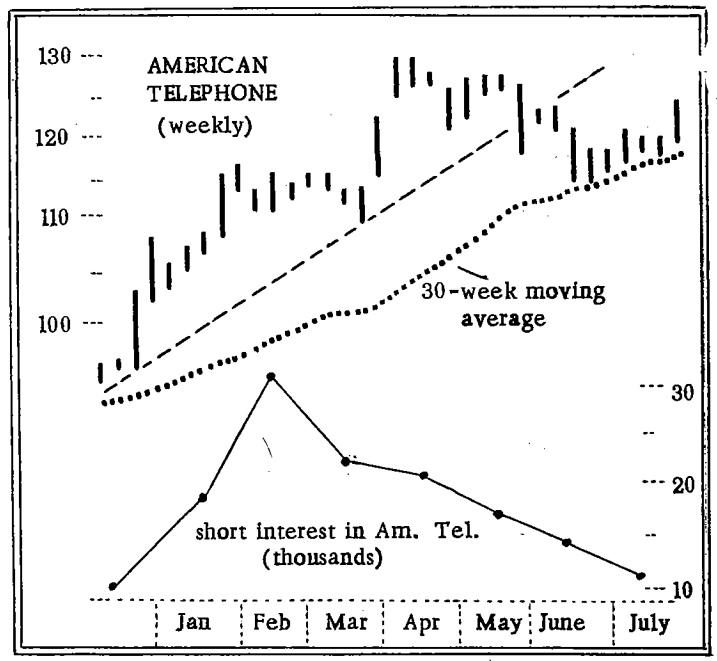
International Harvester has been adversely affected by the Canadian and mid-West drought. It dipped under the 52 level, which had been important support, and also broke below its M. A. (now 51). With the current rally HR has advanced above its M. A. again, but heavy resistance should be encountered in the 52-55 area.

U. S. Steel broke below its M. A. in June, then rallied above it last week (M. A. now 85 3/4). Steel should run into a lot of supply in the 88-92 area.

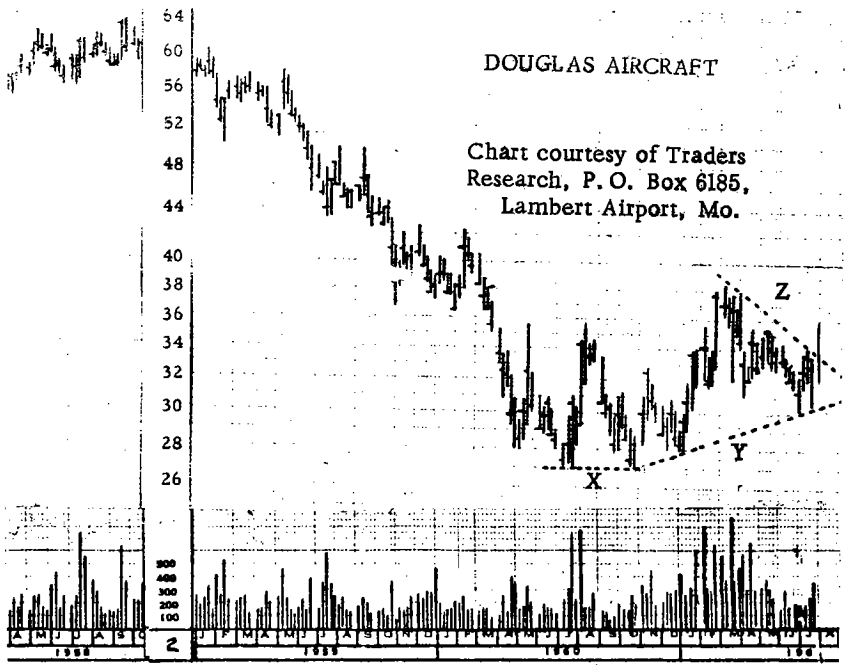
Sears Roebuck continues to be one of the strongest retail stocks. Its M. A. is now 61, and on the recent dip it never dropped within 7 points of that figure. I continue to list S as bullish.

Anaconda and the rest of the coppers will be helped by the deteriorating situation in British Guiana. The communist Dr. Jagan is almost certain to win the August 21 election there, and this will mean that the extremely important S. American Bauxite (aluminum ore) reserves are in jeopardy. Since copper is the best substitute for aluminum, the copper stocks have been firm in the face of the weakness in aluminum issues. Anaconda (see Letter 149) broke below its M. A. (now 55 1/4), then rallied with the other copper stocks. If for no other reason, Anaconda is a speculation on political developments.

American Telephone (T) has shown a decreasing short interest for five consecutive months (see chart). In late May the stock broke a well established trendline (dashed line on chart). I have not been bullish on T for the aforementioned reasons; nevertheless on the May decline T held just above its its M. A. Then for six consecutive weeks T worked higher, holding persistently above its rising M. A. as it advanced. The M. A. on T is now 118, and I would sell the stock if it closed under that figure.



Douglas Aircraft collapsed from 93 in 1956 to a low of 27 in 1960. It formed a "double bottom" at 27 (trendline marked X on chart), then rallied to 38 1/2 in early 1961. On its most recent reaction, Douglas held above the trendline marked Y. In the last few weeks Douglas has rallied above the Z trendline and thus would appear to be heading higher. The stock would seem to be a good speculation and should be bought on any dip.



(Written Thursday, August 3rd - 1 P.M.)

Note: This writer has not had more than a three-day week end in the last fifteen months. I am leaving tomorrow for an eight or nine day vacation, and there will consequently be a little lag between this Letter and Letter 153. Over the next week I will be filling in my charts in the Cactus country a few miles east of the Pacific and a few miles north of the Mexican border (San Diego is the name). With our Cuban neighbors so active in the air, of course, there is always the possibility that I will be spending a vacation in Havana.